

Financial Markets



Irving Trust

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Economic Research &
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(Noon)

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Over the past month or so interest rates have been trending upward. Now we have gotten to the point where more and more analysts are publicly saying that the Fed has tightened. Speculation has intensified that the prime rate might rise. The question of the week therefore is will the prime rate rise.

By most formulas, the cost of funds to banks would indicate that the prime rate should rise. The easiest benchmark calculation compares the prime rate of 11% to the CD rate grossed-up for reserve requirements plus the cost of FDIC insurance. Three-month CD money at 10% costs 10.3% after paying for reserve requirements and 10.38% after FDIC insurance, leaving a spread of about 60 basis points between the cost of three-month money and prime. This spread is small by recent standards. Thus it's appropriate to speak of there being upward pressure on the prime rate. But upward pressure isn't the same as a rate increase, and I would still be reluctant to forecast a prime rate increase as likely in the near future.

First of all, the recent upward move in Fed funds may be an artificial or technical phenomenon. Wednesday was a settlement date for the two-week reserve maintenance period. Pressure on Thursday was due to a tax date. Over a longer time frame, Fed funds have been trending up, but we can't say for sure that they are trading at 10% now. So the market is still struggling to pin down the level of the underlying funds rate. This is made more difficult by upward pressure imparted by usual quarter-end forces and other special factors.

It's hard to forecast that the Fed will purposefully let the funds rate trade consistently above 10%. The FOMC's band of 6% to 10% has been in place for over a year. So, should it be changed, the Fed would have to admit that it had tightened. Before the Fed could agree to do this and to take the heat, it would want to be sure that the economy is really overheating. The economy is growing fast--it's not yet overheating.

This brings us back to the prime rate. If Fed funds are only temporarily firm, will the prime go up? The answer is no. Banks will have to become convinced that the high level of rates will endure before they lift the prime. The banks' expected future funding costs may be lower than current rates suggest, so the lending spread calculated above may be less than the banks think it will actually turn out to be. But this argument lives in the realm of the forecasted and expected. Such an existence is always in great peril. The correctness rests on what the Fed actually does. It's pretty clear that the Fed has tightened somewhat in recent weeks. The next important issue is how far will it go? That is what's critical for the prime rate.

Robert A. Brusca



Irving Trust

Market Yields

	3/16/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	10.50%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	9.25	9.75	8.63
Repurchase Agreements	9.65	9.55	8.63
U.S. Treasury Issues			
Bills			
3 months	9.79	9.71	8.70
6 months	10.17	10.13	8.94
1 year	10.54	10.41	9.18
Coupons			
2 years	11.18	11.20	9.75
4 years	11.72	11.76	10.03
7 years	12.13	12.18	10.44
10 years	12.23	12.30	10.56
Long Bond	12.32	12.40	10.68
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.85	9.80	8.70
3 months	10.05	10.00	8.80
6 months	10.35	10.25	9.00
1 year	10.85	10.75	9.20
Banker's Acceptances			
1 month	9.83	9.88	8.70
3 months	10.07	10.10	8.80
6 months	10.48	10.43	9.05
Eurodollar Deposits			
1 month	10.19	10.19	9.19
2 months	10.31	10.31	9.25
3 months	10.44	10.44	9.38
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.90	9.85	8.51
1 month	10.02	9.86	8.82
3 months	9.97	9.87	8.81
Bank Holding Companies			
1 month	9.33	9.19	8.30
Dealer Placed:			
3 months	10.24	10.13	8.80
New AA Corporate Utility Bond	13.40	13.55	11.95
Tax Exempt			
6 month Project Notes	5.60	5.35	4.60
1 year AAA Bond	5.60	5.70	5.10
5 year AAA Bond	7.00	7.00	6.00
20 year AAA Bond	9.40	9.40	8.50

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

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